Brazil Orange Book

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More sectors feel the slowdown

With information available through November 25, 2011

Sections:

Summary

More sectors in the Brazilian economy started to show weakness between October and November. Weaker sales for large retailers and shopping malls and a clearer slowdown in the pace of residential real-estate sales were the most visible trends.

More recently, however, interest-rate cuts and credit measures taken by the government have created optimism regarding the Christmas shopping season. Orders placed by retailers of durable and semi-durable consumer goods to manufacturers have been reported to be relatively strong.

The service sector marches on, as one of the few areas of the economy to have been virtually unaffected by the economic deceleration.

The relative stability of the financial markets in October improved the outlook for investment after a particularly stressed situation in September. Sales of machinery, equipment and heavy vehicles were good volume-wise but relied on intensive sales efforts and special payment (and price) conditions.

The commodity sector was weighed down by worsening international financing conditions and the slide in prices. But crop expansion is expected, except in specific cases such as sugarcane.

The labor market remains tight, but evidence of decompression is mounting. Inflation will

likely remain under control due to the marginal decline in demand and the high competitiveness of tradable goods.

In short, the economy slowed down, particularly between September and October. On the other hand, there is an expectation, in some segments, of a pick-up at the end of the year and in 2012, fueled by the wave of government incentives.

Our view: Activity is decelerating, and global uncertainties will likely prevent demand from responding to the government's stimulus measures in the short term. In this environment, the pick-up in orders for the Christmas season may increase the risk of high inventories in early 2012. On the other hand, anecdotal evidence reinforces the domestic demand potential and investment opportunities in the country. We are therefore confident about the prospects for a recovery in activity over the course of 2012, as the external scenario stabilizes and economic policy stimuli take hold.

Retail and Service Sales

Retail sales were disappointing in September and October. Though not dramatic, a loss of momentum in demand was registered. The trend was particularly noticeable among large retailers and those with stores in shopping malls.

On the flip side, orders to those who supply to retailers – manufacturers of durable and non-durable goods – remain strong. Appliance and electronics manufacturers even reported some acceleration beyond the normal seasonality.

Some retailers see credit incentives by the government (such as lower interest rates and the reversal of some of the macroprudential measures taken late last year) as the reason for the increase in orders for the year-end season. They expect good, if not great, Christmas sales.

As reported in the previous issue of The Orange Book, the Brazilian automotive sector has been particularly hurt by tighter credit conditions and lower consumer confidence this year. Inventories continued to rise in October and remained high in November, even with more stable final sales. Related segments such as auto parts, accessories and tires also reported difficulties.

Along the same lines, suppliers of inputs for manufacturers in general (of vehicles and other durable consumer goods) also reported poor sales in October and November.

On the other hand, some consumer-goods segments barely registered the deceleration. This was the case for food, women's fashion (cosmetics, jewelry), personal care and beauty products, and school supplies.

The service sector, also, has been virtually unaffected by the economic slowdown so far. In air transportation, for instance, the market continues to expand, with new routes being opened. Likewise, the hospitality industry experienced high occupancy rates for businesspeople and tourists alike in October and November. Declines were registered only in the number of foreign guests (probably a result of the global economic crisis) and events. Some restaurants also reported somewhat below-trend demand in the last two months.

Services related to past growth in the construction sector, such as property security (for homes, shopping malls, etc.) are still seeing very intense business.

Investment

The relative improvement in risk-aversion levels following the September peak has generated some heat in the investment sector. Our systematic research with a broad range of Itaú's clients indicated that in October and November business confidence partly rebounded from the sharp drop seen in September.

Large capital-goods manufacturers reported good sales volumes in October and early November, though these volumes were attained through promotions and exceptionally favorable payment conditions. Overall, sales were geared toward the industrial sector, but specific mention was also made of commodity production (mining, oil, grains). In fact, farm-equipment sales had in October their best performance in 2011.

Competition with imported capital-goods intensified. Asian products have shown significant improvements in quality in recent years, even as their producers have kept costs low. The gap in the machinery and equipment trade balance has been widening. Mechanical capital-goods imports reached US$22.0 billion in 2011, while exports were only US$8.6 billion.

Regarding public investment, activity remains low for large construction projects. But information about public concessions suggests that the flow of government investment, interrupted in the beginning of the year, is already picking up and should accelerate by the end of the year and into early 2012.

Demand for heavy vehicles, for which the deceleration was more intense in August and September, improved somewhat in October and November. But as was the case for machinery, the sales effort was significant.

Volatility in the exchange rate and international economic uncertainty continue to be mentioned as factors delaying new investment – along with high labor and energy costs, restrictions on the importing of inputs, and difficulty finding skilled workers.

Facing this reality, some companies revealed expansion plans in other countries, like Paraguay and Uruguay. Output migration to Asia was also mentioned.

Deteriorating financing conditions, especially abroad, have been felt by many sectors. In some cases, however, the decline in domestic interest rates neutralized this effect.

Construction and Real Estate

Home sales continued to slow, in line with the decline in consumer confidence (which curbs demand) and the perception of greater household indebtedness (which inhibits supply).

Sales performance in October was classified as reasonable to good. Overall, sales speed is lower than in 2010 but still higher than in 2008 and 2009. Additionally, the government program "Minha Casa Minha Vida 2" continues to boost the low-income housing segment. Many large companies in the industry already get, or intend to get, 50% of their revenues from this type of project.

One reflex of demand contraction is the slower pace of launches scheduled for the coming months, so as to avoid high inventories.

Decelerations in launches tend to be reflected in sales of building supplies. This sector has been growing more slowly than retail, largely due to competition from imports. The deficit in the construction-material trade balance, which was US$1.6 billion in 2010, could widen to US$2 billion in 2011. The main imports are metals, valves, plastics, electric material, glass and long steel.

On the other hand, the commercial real-estate segment is not feeling the slowdown, particularly regarding leases to logistics and retail companies. Industrial leases, especially in the auto sector, remain weaker. Demand by foreign companies remains firm, though these companies are taking longer to make decisions – likely an effect of the more difficult economic situation in their home countries.

The shopping mall segment is among the busiest in Brazilian commercial construction. Industry projections anticipate three times more shopping malls being launched in 2012 than in 2011. Notwithstanding the high number of launches, vacancy rates remain low, at around 1.5% (regarded as technical vacancy).

Commodities

In the agriculture sector, lower prices and worsening international credit conditions are weighing on the crop outlook. However, sector data point to an expansion in production in 2011/12, particularly for soybeans, cotton, coffee, orange and corn. Regionally, production fell only in the Northern region in 2011.

Sales in the fertilizer segment were good in the second half, with most players taking in revenues that were close to or above the numbers predicted early in the year. Good deliveries of fertilizer mixers to resellers around the country confirmed expectations, with deliveries remaining at record levels in the second half of 2011.

Despite solid demand, there is discomfort with the elevated fertilizer prices. Given the large share of imports in the final product mix, domestic prices are tightly correlated to input prices in global markets. Prices for phosphate byproducts, for instance, have stabilized since September but remain approximately 40% higher than last year.

The sugarcane crop continues to be an exception. The 2011/12 harvest, which is already nearly over, was disappointing, and the industry worked with spare capacity in the period. Several factors contributed to the poor results, including the weather (first drought, then frosts in the Center-South region), but the main factor for this crop as well as the next one is the non-renewal of plants. In recent years, renewal efforts have been badly hurt by a lack of investment incentives. Despite some indications that the government would provide credit facilities and fiscal stimuli, nothing concrete was done. This is worrisome, as 50% of the car fleet in Brazil is already flex-fuel.

Logistical bottlenecks continue to be the greatest curb on crop production in Brazil. For many crops, the production cost in Brazil is no longer the lowest in the word. The difficulty of moving crops out of the Center-West, the overcrowded port structure and the lack of workers are hurting competitiveness. Additionally, the cost of storage has been rising, pushed up by, among other factors, the recently implemented IOF tax on FX derivatives.

On industrial commodities, the reduction in international prices is a problem, but investments have been maintained, particularly in underground mining.

Labor Market, Wages and Prices

The labor market continues to be widely regarded as overheated. Some accommodation has been occurring: while hiring skilled workers continues to be difficult, unskilled workers are relatively more available. Still, nominal wages are rising by 9%-10%, except in rare cases in which there is only a correction of past inflation.

The global deceleration and the drop in commodity prices brought some cost relief to selected sectors, partly decompressing margins. Due to fierce competition with imports, the capacity to pass through past losses is still quite limited. The exception is still the service sector, where prices are expected to rise in 2012 at the same pace as in 2011.

The outlook for agricultural prices is still one of stability, even with the drop in global aggregate demand, thanks to supply restrictions (production costs, weather).

In the property sector, the significant real increase in prices seen in the first half lost momentum. According to industry reports, prices have tracked the construction-cost index INCC in the past six months, a pattern that is expected to continue.

Our view

The economy is slowing down and will likely continue to do so. Exports, for instance, have not yet been impacted by the drop in global activity. Under this clouded outlook, domestic demand is not likely to respond quickly to the government stimuli.

In that sense, the pick-up in orders for the Christmas season may also increase the risk of high inventories in early 2012. We expect GDP growth to end 2011 at 3%, less than we expected at the beginning of the year.

On the other hand, anecdotal evidence makes clearer the domestic demand potential and the investment opportunities in Brazil. We are therefore confident about the prospects for a recovery in activity over the course of 2012, as the external scenario stabilizes and economic policy stimuli take hold.

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